

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission
On Its Own Motion

vs.

Illinois Bell Telephone Company;
et al.

97-0601

Investigation into Non-Cost Based
Access Charge Rate Elements in
the Intrastate Access Charges of
Incumbent Local Exchange
Carriers in Illinois

Illinois Commerce Commission
On Its Own Motion

97-0602

Investigation into Implicit
Universal Service Subsidies in
Intrastate Access Charges and to
Investigate how these Subsidies
should be Treated in the Future

Illinois Commerce Commission
On Its Own Motion

97-0516

(Consolidated)

Investigation into the
Reasonableness of the LS2 Rate of
Illinois Bell Telephone Company

ORDER

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Witness

Date 1/5/03 Reporter *and*

March 29, 2000

TABLE OF CONTENTS

I. PROCEDURAL BACKGROUND	1
II. HISTORY OF ACCESS CHARGES	4
A. The ICC's Access Charge Policy.....	5
B. The FCC's 1997 Access Charge Reform Policies	6
C. Specific Access Charges.....	7
D. The Interstate PICC	9
III. WHETHER ACCESS CHARGES SHOULD BE PRICED BASED ON ECONOMIC COST.....	10
A. Staff.....	10
1. Cost Based Intrastate Access Charges	10
2. Non-Cost Based Intrastate Access Charges.....	11
3. Proposals to Eliminate Non-Cost Based Access Charge Rate Elements	12
4. Flow Through Issues.....	13
B. AT&T	14
C. MCIW	21
D. Sprint.....	30
E. Ameritech	31
1. Non-Cost-Based Access Charges	31
2. Cost Based Access Charges	32
3. Flow Through	36
F. GTE	36
G. Hearing Examiner's Proposed Order	37

1. Briefs on Exceptions	37
a. The IXC exceptions	37
b. The ILEC Exceptions.....	38
c. Gallatin River Exceptions.....	39
d. Staff Exceptions	39
e. City of Chicago Exceptions	40
2. Replies to Exceptions.....	40
a. The IXC Replies	40
b. ILEC Replies	44
c. Gallatin River Replies	45
d. Staff's Replies.....	46
G. Commission Analysis and Conclusion	47
1. Non-Cost-Based Access Rate Elements.....	47
2. Future Pricing Of Cost-Based Access Rate Elements	48
3. Revenue Neutrality.....	52
4. Flow Through	53
IV. GALLATIN RIVER.....	54
A. AT&T	54
B. Commission Analysis and Conclusion.....	55
V. UNIVERSAL SERVICE AND RATE REBALANCING	55
A. Staff.....	55
1. FCC Actions Regarding The Definition Of Universal Service.....	55
2. ICC Actions Regarding the Definition of Universal Service.....	56
3. Staff's Recommendations Regarding the Definition of Universal Service.....	56

4. Number and Type of Access Lines that Should be Eligible for Intrastate Universal Service Support	56
5. Measuring the Cost of Providing Universal Service	57
6. Staff's Recommendation for a Costing Method to Determine Universal Service	58
7. Recovery Mechanisms for the Cost of Providing Universal Service.....	60
8. Rate Rebalancing.....	60
B. AT&T	62
1. The Price of the NAL Should Continue to be Based on the LRSIC of the NAL.....	62
2. The Definition of Universal Service should be Limited to the Primary Residential Network Access Lines.....	63
3. The Commission Should use the Entire ILEC State Area to Demonstrate Whether an ILEC Needs Universal Service Support	64
C. MCIW	65
1. The Definition of Universal Service Should Include Some Level of Local Usage	65
2. The State's Universal Service Effort Should be Limited to Services Provided only over Primary Residential Lines	66
3. The Cost of Universal Service.....	66
4. Determination of Funding Need	67
5. Other Universal Service Fund Issues.....	67
D. Sprint.....	69
E. Ameritech	70
1. Rate Rebalancing.....	70
2. Staff's Methodology.....	70
3. Universal Service Funding	75
4. Types of Services Supported	75

5. Eligibility for Universal Service Funding	75
6. Competitive Neutrality	76
F. GTE	76
G. City of Chicago	77
H. Commission Analysis and Conclusion	78
VI. PHASE III ISSUES	79
VII. FINDINGS AND ORDERING PARAGRAPHS	80

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ORDER

By the Commission:

I. PROCEDURAL BACKGROUND

This consolidated proceeding was originally initiated as three separate dockets. First, on October 8, 1997, the Illinois Commerce Commission (the "Commission" or "ICC") initiated Docket 97-0516 to investigate whether Illinois Bell Telephone Co.'s ("Ameritech") intrastate Local Switching ("LS2") rate increases, filed on August 1, 1997, and in effect between September 16, 1997, and January 3, 1998, were just, reasonable and nondiscriminatory. See Initiating Order, ICC Docket No. 97-0516, pp. 1-2. Ameritech was the only respondent in Docket 97-0516. *Id.* at 2. AT&T

Communications of Illinois, Inc. ("AT&T"), MCI Telecommunications Corporation, now MCIWorldCom ("MCIW"), the Illinois Attorney General and McLeod USA Telecommunications Services, Inc. intervened.

On November 19, 1997, the Commission initiated Dockets 97-0601 and 97-0602. The Commission initiated Docket 97-0601 to investigate the non-cost based access charge rate elements contained in the intrastate access charges of incumbent LECs in Illinois. See Initiating Order, ICC Docket 97-0601. Also, the Commission initiated Docket 97-0602 to investigate whether implicit universal service subsidies are contained in intrastate access charges, and how these subsidies should be treated in the future. Staff Report, Dockets 97-0601/0602, consol. (October 24, 1997), at 1-2. The Commission initiated these two dockets in response to the passage of the federal Telecommunications Act of 1996 ("Act"), which amended the Federal Communications Act of 1934, and the actions taken by the Federal Commerce Commission ("FCC"), under the Act. *Id.*

The Commission named the following companies as respondents in Docket 97-0601: Adams Telephone Company; Alhambra-Grantfork Telephone Company; C-R Telephone Company; Cambridge Telephone Company; Cass Telephone Company; Central Telephone Company of Illinois; Crossville Telephone Company; Egyptian Telephone Cooperative Association, Inc.; El Paso Telephone Company; Flat Rock Mutual Telephone Company; GTE North Incorporated; Geneseo Telephone Company; Grafton Telephone Company; Gridley Telephone Company; GTE South Incorporated; Hamilton County Telephone Cooperative; Harrisonville Telephone Company; Henry County Telephone Company; Home Telephone Company; Illinois Bell Telephone Company; Illinois Consolidated Telephone Company; La Harpe Telephone Company; Leaf River Telephone Company; Madison Telephone Company; Marseilles Telephone Company; McDonough Telephone Cooperative; McNabb Telephone Company; Metamora Telephone Company; Mid Century Telephone Company; Montrose Mutual Telephone Company; Moultrie Independent Telephone Company; New Windsor Telephone Company; Odin Telephone Exchange Inc.; Reynolds Telephone Company; Shawnee Telephone Company, Inc.; Tonica Telephone Company; Viola Home Telephone Company; Wabash Telephone Cooperative; Woodhull Community Telephone Company; and Yates City Telephone Company.

The following companies also intervened in Docket 97-0601: the Illinois Independent Telephone Association; AT&T; MCIW; Frontier Communications of Illinois, Inc.; Frontier Communications of Lakeside, Inc.; Frontier Communications of De Pue, Inc.; Frontier Communications of Orion, Inc.; Frontier Communications of Mt. Pulaski, Inc.; Frontier Communications - Midland, Inc.; Frontier Communications - Schulyer, Inc.; Frontier Communications Prairie, Inc. (collectively referred to as "Frontier"); Teleport Communications Group Inc.; McLeod USA Telecommunications Services, Inc.; and the Illinois Attorney General.

The Commission named the following companies as respondents in Docket 97-0602: GTE North Incorporated; GTE South Incorporated (collectively referred to as "GTE"); and Ameritech. The following companies intervened: SBMS Illinois Services, Inc.; Illinois Independent Telephone Association; Cook County State's Attorneys Office; AT&T; MCIW; Teleport Communications Group, Inc.; McLeod USA Telecommunications Services, Inc.; and the Illinois Attorney General.

Ameritech moved to consolidate Dockets 97-0516 and 97-0601 (Ameritech Motion to Consolidate, at 1-4) and Staff made a motion to consolidate Dockets 97-0601 and 97-0602. March 23, 1998, Status Hearing, Tr. at 29. No parties objected to the motions to consolidate. *Id.* Staff also moved, without objection, to name the respondents in Docket No. 97-0601 as respondents in Docket No. 97-0602. *Id.* The Hearing Examiner granted these motions to consolidate on April 9, 1998.

During industry workshops, both Staff and the parties to these proceedings agreed to divide the proceedings into three phases because of the complexity and number of issues contained in the dockets. Staff Ex. 1.00, p. 4; Ameritech Ex. 1.0, p 2. By agreement between Staff and the parties, the first phase (Phase I) of this proceeding addressed tariff compliance issues as they relate to incumbent LECs in Illinois mirroring their January 1, 1998 interstate access charge tariffs on the intrastate level. *Id.* Phase I also addressed the justness and reasonableness of Ameritech's LS2 rate increases that the Commission identified for investigation in Docket 97-0516. *Id.* A final order was issued by the Commission in Phase I on December 16, 1998. The Commission's Phase I Order resolved all issues in ICC Docket No. 97-0516.

Pursuant to agreement among the parties, the purpose of Phase II, which is limited to the non-rural incumbent LECs ("ILECs"), is to: (1) determine how to price non-rural ILEC intrastate access charges on a going forward basis; (2) identify implicit universal service subsidies in non-rural ILEC intrastate access charges and identify how those subsidies, if any, should be treated in the future; (3) to ascertain the criteria to be applied to non-rural ILEC rate rebalancing proposals; and (4) to determine what service(s) should be included in the definition of universal service for state funding purposes and how to properly determine the cost of the service(s).

Ms. Rasha Toppozada-Yow and Mr. Jason Hendricks filed Direct Testimony on behalf of the Staff of the Illinois Commerce Commission ("Staff") on November 19, 1998. Direct testimony was filed by Mr. David Gebhardt, Ms. Mary Ann Heinzen and Mr. Paul Van Leishout on behalf of Ameritech Illinois ("Ameritech"), by Ms. Cathleen M. Conway and Mr. James D. Webber on behalf of AT&T, by Ms. Patricia Kravtin on behalf of the City of Chicago, by Dr. Edward Beauvais and Mr. Terry Dye on behalf of GTE North Incorporated and GTE South Incorporated ("GTE"), by Ms. Charlotte TerKeurst and Mr. Merwin Sands on behalf of MCIW and by Mr. David Bishop on behalf of Sprint Communications LP ("Sprint") on January 4, 1999.

On January 11, 1999, the Hearing Examiner continued the hearings until March 3, 4, and 5, 1999. In response to the direct testimony filed, rebuttal testimony was filed by Mr. David Gebhardt, Ms. Mary Ann Heinzen, Dr. Cale Case and Mr. J. Thomas O'Brien on behalf of Ameritech, by Ms. Cathleen M. Conway and Mr. James D. Webber on behalf of AT&T, by Ms. Patricia Kravtin on behalf of the City of Chicago, by Dr. Edward Beauvais and Mr. Terry Dye on behalf of GTE, by Ms. Charlotte TerKeurst on behalf of MCIW, by Mr. David Bishop on behalf of Sprint, and by Ms. Rasha Toppozada-Yow and Mr. Jason Hendricks on behalf of Staff on February 22, 1999. On March 17, 1999, the Hearing Examiner issued another continuance and set the hearings for March 35 and 26, 1999.

An evidentiary hearing was conducted in this matter on March 25, 1999 before duly appointed Hearing Examiner Donald Woods, where all the pre-filed testimony was admitted into evidence, and the parties elicited cross-examination, and at the conclusion of the hearing the record was marked "Heard and Taken."

II. HISTORY OF ACCESS CHARGES

Staff witness Ms. Yow, Chief of the Policy Section within the Telecommunications Division of the Illinois Commerce Commission, provided a comprehensive historical explanation of access charges. She explained that ILECs own the local exchange telecommunications facilities that connect the telecommunications network to the end users' premises. Consequently, a portion of the ILECs' local facilities need to be used to access the interexchange network and complete interexchange calls. Either one or two ILECs' facilities may be used to transmit a interexchange call depending on whether the call transcends the service territory boundaries of the ILEC that originates the interexchange call and enters an area served by a second ILEC. ICC Staff Ex. 1.00 (Yow), at 4.

For example, when an end user originates a interexchange call, the call must travel over the ILEC's facilities whose local exchange customer originates the interexchange call ("originating ILEC") to reach the interexchange carrier's ("IXC") network. The IXC then transmits the call to the ILEC that owns the local facilities serving the called party ("terminating ILEC"). The IXC then hands off the call to the terminating ILEC, and the terminating ILEC transmits the call over its facilities to the called party. ICC Staff Ex. 1.00 (Yow), at 4-5.

ILECs incur costs when they provide their facilities to end users and IXCs for the purpose of completing interexchange calls. Accordingly, ILECs assess charges to IXCs to compensate the ILECs for the use of their facilities in originating and terminating interexchange calls. These charges are known as access charges. ICC Staff Ex. 1.00 (Yow), at 5.

There are two types of access charges: (i) originating access charges and (ii) terminating access charges, which for the most part are mirror images of each other in

terms of structure and rate element composition. Originating access charges refer to those charges assessed by the ILEC whose customer originates the interexchange call. Terminating access charges refer to those charges assessed by the ILEC whose customer receives the interexchange call. ICC Staff Ex. 1.00 (Yow), at 6-7.

Access charges are addressed jurisdictionally by two entities. Interstate access charges are overseen by the FCC and assessed to IXC's for interstate calls. Intrastate access charges which are overseen by State commissions and assessed to IXC's for intrastate calls. Access charges are assessed to IXC's with the exception of the interstate Subscriber Line Charge ("SLC"), also known as the interstate End User Common Line ("EUCL") charge, which is assessed directly on end users by ILECs. The interstate SLC (or EUCL) is a flat rate charge that is intended to recover a portion of the ILEC's loops costs which are allocated to the interstate jurisdiction. ICC Staff Ex. 1.00 (Yow), at 5-6.

Access charges are composed of a variety of rate elements. Some of these rate elements are assessed on a per-minute, or usage sensitive, basis while others are assessed on a flat rate, or non-usage sensitive basis. Some of these rate elements recover costs not associated with the origination or termination of interexchange calls. For instance, there are cost-based access charge rate elements that are assessed by ILECs to compensate them for the use of their network to originate and terminate interexchange calls. Examples of these cost-based access charge rate elements are local switching charges assessed for switching interexchange calls, and transport charges assessed for transporting interexchange calls from one point to another via the ILECs' networks. Traditionally, cost-based access charge rate elements have been set at levels that recover the cost of providing the access service as well as a contribution towards shared and common costs. ICC Staff Ex. 1.00 (Yow), at 6.

There are also non-cost based access charges that recover costs unrelated to the ILEC's provision of access services. These non-cost based access charges include portions of the interstate residual Transport Interconnection Charge ("residual TIC") and its intrastate counterpart, the Residual Interconnection Charge ("RIC"). These non-cost based access charges also include portions of the interstate Primary Interexchange Carrier Charge ("PICC") and its intrastate counterpart. ICC Staff Ex. 1.00 (Yow), at 7.

A. The ICC's Access Charge Policy

In its Fourth Interim Order in Docket No. 83-0142, the Commission approved a Stipulated Agreement requiring all LECs in Illinois to mirror the interstate rate structure and rate levels on the state level. ICC Staff Ex. 1.00 (Yow), at 7, *citing* ICC Docket No. 83-0142, Fourth Interim Order at 34. The ICC, however, deviated from mirroring the interstate access charge rate structure when determining the appropriate recovery mechanisms of the intrastate CCLC and intrastate line port charges. Specifically, the ICC approved stipulated agreements that provided for the phase out of the intrastate CCLC (ICC Docket 83-0142, Fourth Interim Order (adopting the Alternative Plan)) and

for the removal of NTS line port (NTS central office equipment) costs from intrastate access charges. ICC Staff Ex. 1.00 (Yow), at 7, *citing* ICC Docket No. 83-0142, Twenty Seventh, 30 Sixth, 30 Ninth and Forty Sixth Interim Orders. Instead of recovering these costs through access charges assessed on interexchange carriers, the Commission concluded that these charges should be recovered directly from end users via NTS end user charges. Moreover, the ICC adopted lower, cost-based rates for local traffic termination in Ameritech Illinois' exchanges and stated that "[u]ltimately, the same rates should apply for termination regardless of the type of originating carrier, and we formally, establish that goal here." ICC Staff Ex. 1.00 (Yow), at 7-8 *citing* Order, ICC Dockets No. 94-0096, 94-0117, 94-0146 and 94-0301 (Consol.), at 98.

The Commission has also indicated its access reform policy in comments to the FCC in its Access Charge Reform proceeding, where the Commission recognized that the interstate access charge system suffered from several deficiencies. (ICC Comments, FCC's Access Charge Proceeding, at 7.) The Commission took the position that the interstate system's deficiencies should be addressed, for the most part, through reliance on a market based approach to determine appropriate rates whenever possible. (*Id.* at 7, 16.) The Commission preferred a market-based approach primarily because of ease of administration. The other suggested approach ("the prescriptive approach") requires an elaborate set of rules and regulations and on-going efforts by the FCC and state agencies. (*Id.* at 16, 18.) The Commission also believed that giving ILECs the flexibility to set access charges and modify the rate structure would rationalize the interstate pricing structure and more accurately reflect the costs of providing access. (*Id.* at 16.) ICC Staff Ex. 1.00 (Yow), at 8.

Despite supporting a market-based approach, the Commission also recognized that ILECs may not be as interested in correcting implicit subsidies and the anti-competitive problems that result from the interstate access charge system. Accordingly, the Commission stated that some rate structure and level changes may be needed to assist with the development of competition and to deal with the remaining shortcomings of the current system. (*Id.* at 7, 17.) The Commission recommended several modifications to interstate access charges including: (1) geographically de-averaging access charges, (2) recovering NTS costs on an NTS basis, (3) reallocating TIC related revenues to other access charges where cost causation can be established, and (4) phasing out the residual TIC revenues using rate reductions required by the federal price cap mechanism. (*Id.* at 9, 12-15.) ICC Staff Ex. 1.00 (Yow), at 8-9.

B. The FCC's 1997 Access Charge Reform Policies

The FCC, in its 1997 Access Charge Reform Order, recognized certain inefficiencies in the interstate access charge system, and concluded that those inefficiencies are better addressed through a market-based approach than a prescriptive approach. (Access Charge Reform Order at ¶¶ 28-31, 42-44.) The FCC explained that it adopted a market-based rather than prescriptive approach for many reasons. ICC Staff Ex. 1.00 (Yow), at 9.

The FCC, however, did not decide that it would rely solely on market-based approaches to effectuate access charge reform. The FCC recognized that competition is unlikely to develop at the same rate in all locations, and that some services would likely be subject to competition more rapidly than others. Consequently, the FCC concluded that access rates in those areas facing little competition would continue to be subject to existing safeguards afforded by federal price cap regulation. (FCC Access Charge Order at ¶ 267.) ICC Staff Ex. 1.00 (Yow), at 11.

In addition, the FCC adapted a prescriptive "backstop" to its market-based approach that would serve to ensure that all interstate access customers receive the benefits of more efficient pricing, even in those places and for those services where competition does not develop quickly. To implement its backstop to market-based access charge reform, the FCC required each incumbent price cap LEC to file a cost study no later than February 8, 2001, demonstrating the forward looking (incremental and common) costs of providing those interstate access services that remain subject to price cap regulation because they do not face substantial competition. ILECs could be required, at that time, either to set their rates in accordance with the benchmarks or to justify their alternative rates with cost studies. (*Id.* at ¶ 268.) ICC Staff Ex. 1.00 (Yow), at 11.

Finally, the FCC instituted some prescriptive measures to address certain inefficiencies in the interstate access charge system. (*Id.* at ¶ 43.) Those prescriptive measures were consistent with the prescriptive measures recommended by the Commission. ICC Staff Ex. 1.00 (Yow), at 12.

C. Specific Access Charges

Ms. Yow also provided an explanation of the residual TIC, which has an intrastate counterpart known as the RIC, as an example of a non-cost based rate that is currently included in ILECs' access charges. Ms. Yow explained that following divestiture, the ILECs charged per-minute, distance-sensitive transport rates regardless of how they incurred their underlying costs. In 1992, the FCC restructured ILECs' interstate transport access rates to create a more cost based framework. To maintain revenue neutrality between this new rate structure and the pre-existing rate structure, the FCC created the interstate TIC, which recovered the difference between carriers' revenues from the FCC's new rates and the revenues that carriers would have realized had the pre-existing rates remained in effect. The interstate TIC was intended to be a transitional rate element. The interstate TIC is assessed on a per-minute basis on all switched access minutes. ICC Staff Ex. 1.00 (Yow), at 12.

The FCC modified the interstate TIC in its Access Charge Reform Order, in which the FCC concluded that the interstate TIC has caused several inefficiencies in the interstate access charge rate structure, and has had a negative impact on competition in the interstate access market. (FCC's Access Charge Order at ¶ 212.)

ICC Staff Ex. 1.00 (Yow), at 12-13. Consequently, Ms. Yow explained that the FCC decided to do three things. First, the FCC concluded that certain portions of the interstate TIC recovered costs that were more appropriately allocated to other access rate elements. Accordingly, the FCC reallocated a portion of the revenue recovered by the interstate TIC to a variety of other access rate elements. (FCC's Access Charge Order at ¶ 212.) The FCC directed price cap LECs to identify the appropriate costs for reallocation in accordance with the FCC's order, and to reallocate those costs to the appropriate interstate access elements. The majority of these reallocations were carried out in filings that were effective on January 1, 1998. However, the portions of costs which are to be reallocated to the access rate element known as the interstate tandem switching rate is being reallocated over a three year period that beginning January 1, 1998, and ending on January 1, 2000. (*Id.* at ¶¶ 167, 169.) Consequently, a portion of interstate tandem switching access costs are still being recovered through the residual TIC despite the fact that they are more appropriately assigned to the tandem switching access rate. ICC Staff Ex. 1.00 (Yow), at 13.

Second, the FCC concluded that the remaining portions of the per-minute interstate TIC, which is referred to as the residual TIC, should gradually be eliminated. To accomplish the elimination of the residual TIC, the FCC ordered ILECs to target their federal price cap productivity reductions to their residual TIC rate elements. (FCC Access Charge Reform Order at ¶¶ 234-235.) However, the FCC recognized that price cap reductions would not result in the immediate elimination of the entire residual TIC. Accordingly, the FCC also directed ILECs to reallocate the remainder of their residual TICs first to their PICC charges, and then through their per-minute terminating switched access rates. (*Id.* at ¶¶ 229-234, 239.) ICC Staff Ex. 1.00 (Yow), at 13-14.

Ms. Yow testified that the amounts that make up the residual TIC, with the exception of the tandem switching revenues, are non-cost based. To the extent that the FCC was able to identify specific, booked costs that the TIC was recovering, it reallocated those costs to the appropriate access service rates. (Access Charge Reform Order at ¶¶ 217-23.) However, Ms. Yow noted that the evidence submitted in the FCC's proceeding was insufficient to allow it to identify the cost basis for the amounts that remained in the residual. (*Id.* at ¶¶ 224-46, 232, 242.) ICC Staff Ex. 1.00 (Yow), at 14.

Regarding the intrastate rate element called the RIC, which is the counterpart to the interstate TIC, Ms. Yow testified that in its Orders in Docket 83-0142, the Commission concluded that interstate access charge rate structures and levels should be mirrored on the state level. ICC Docket No. 83-0142, Fourth Interim Order at 34. As a result, the interstate TIC was mirrored on the state level and labeled the RIC. Further, the FCC's recent modifications made to the interstate TIC, were also mirrored on the state level. Ms. Yow explained that these mirrored modifications impacted Ameritech and GTE differently. Ameritech was able to reallocate the entire amount of its residual RIC to the intrastate PICC. As a result, Ameritech no longer has an RIC. On the other

hand, GTE was not able to reallocate its RIC to the intrastate PICC and, as a result, still has a residual RIC. ICC Staff Ex. 1.00 (Yow), at 14.

D. The Interstate PICC

The FCC in its Access Charge Reform Order concluded that non-traffic sensitive ("NTS") costs should be recovered in an NTS manner. Access Charge Reform Order at ¶¶36. Ms. Yow observed that the FCC, however, recognized that its prior access rate structure failed to recover costs in the preferred manner. To correct the situation, the FCC decided to transfer the recovery of certain NTS costs, which were being recovered in a traffic sensitive ("TS") manner, to NTS rate elements. ICC Staff Ex. 1.00 (Yow), at 15.

Ms. Yow noted that the FCC's prior rate structure allowed ILECs to recover a portion of their loop costs, which are NTS in nature, through a TS rate element assessed on IXCs called the Carrier Common Line Charge ("CCLC"). ILECs were able to recover the remainder of their loop costs through a flat-rate charge on end users called the interstate Subscriber Line charge ("SLC"). Ms. Yow explained that the SLC is assessed in different amounts on different classes of customers, with the amount assessed on residential and single-line business users capped previously at \$6.00. (*Id.* at ¶¶ 67-68.) ICC Staff Ex. 1.00 (Yow), at 15.

Ms. Yow explained that the FCC, in order to eliminate the TS recovery of NTS costs through the CCLC, decided to allow ILECs to transfer their recovery of the cost elements that underlie the CCLC to the SLC, subject to the SLC's ceiling. The FCC also increased the ceilings on the non-primary residential SLC, and the multi-line business SLC to \$5.00 and \$9.00, respectively, to allow ILECs to recover a larger portion of such costs through their SLC. (*Id.* at ¶¶ 71, 78.) ICC Staff Ex. 1.00 (Yow), at 15.

Ms. Yow explained that the FCC, to allow ILEC recovery of the portion of NTS costs that remained in the CCLC, created a new NTS interstate access charge known as the PICC. (*Id.* at ¶ 91.) The FCC capped the interstate PICC at \$.53 for single line residential and single line business customers, at \$1.50 for non-primary residential customers and at \$2.75 for multi-line business customers. These caps are to be increased on an annual basis, subject to certain limits. (*Id.* at ¶¶ 94, 99, 101.) ICC Staff Ex. 1.00 (Yow), at 15-16.

Ms. Yow testified that the FCC designed the PICC to recover, in addition to a portion of the costs formerly recovered through the CCLC, the costs for the following rate elements: (1) interstate CCLC revenues, once the interstate SLC cap is reached; (2) residual TIC revenues not allocable to other rate elements; and (3) interstate line port revenues. The revenues associated with these rate elements are to be shifted to the interstate PICC on an annual basis until they are eliminated or the interstate PICC cap is reached. (FCC's Access Charge Reform Order at ¶¶ 54-66.) Ms. Yow pointed

out that revenues associated with the interstate CCLC and interstate line ports are cost-based, while revenues associated with the residual TIC are non-cost based. (*Id.* at ¶¶ 224-26, 232, 242.) ICC Staff Ex. 1.00 (Yow), at 16.

Ms. Yow explained that the intrastate PICC evolved in Illinois' because ILECs were required to mirror the interstate PICC at the state level, while the Commission also required that intrastate CCLC and line port costs should be recovered on an NTS basis directly from end users and declined to mirror the interstate CCLC and line port charges on the state level. Consequently, Ms. Yow testified that it is improper for ILECs to recover CCLC and line port revenues in their intrastate PICC charges. ICC Staff Ex. 1.00 (Yow), at 16-17. Ms. Yow also testified that any revenues recovered in an intrastate PICC would be non-cost based because the only federal charge that ILECs can mirror in Illinois, and recover through an intrastate PICC, is the residual TIC, which is non-cost based. ICC Staff Ex. 1.00 (Yow), at 17.

III. WHETHER ACCESS CHARGES SHOULD BE PRICED BASED ON ECONOMIC COST

A. Staff

Staff's discussion of access charges was bifurcated into two general areas. Access charge components that are currently based upon the costs of providing those components and access charge components that are not cost based.

1. Cost Based Intrastate Access Charges

Staff recommended that non-rural LECs continue to mirror cost based access charge rate elements, with a minor exception for the intrastate tandem switching rate. Staff Initial Brief, at 19. Specifically, Ms. Yow testified that the Commission should allow non-rural ILECs to allocate the portion of their intrastate tandem switching costs that is still recovered through their intrastate PICC and/or RIC to their intrastate tandem switching rate elements. Their intrastate tandem switching rates should then be capped at the resulting levels. ICC Staff Ex. 1.00 (Yow), at 17.

Ms. Yow based her recommendation on her understanding of the Commission's previously stated position on interstate access charge reform. Specifically, Ms. Yow concluded that the Commission is not likely to support a prescriptive approach to bringing cost based switched access charges closer to their forward looking economic cost. Instead, the Commission appears to prefer relying on market forces to bring cost-based access charges closer to cost. ICC Staff Ex. 1.00 (Yow), at 18.

Ms. Yow agreed with the Commission's position that movement away from a market-based approach towards a prescriptive approach would impose significant regulatory and oversight challenges, on a going forward basis. Further, Ms. Yow

believed that it would not necessarily ensure that access charge rates are established at economically efficient levels. ICC Staff Ex. 1.00 (Yow), at 18.

Ms. Yow noted that IXC's have raised the concern over potential price squeezes if access charges are not set at cost. Ms. Yow testified that in addressing this issue, the FCC concluded that, although an ILEC's control of exchange and exchange access facilities may give it the incentive and ability to engage in a price squeeze, there are currently adequate safeguards against such conduct. These safeguards, Ms. Yow noted, include separation requirements set forth in the fifth Competitive Carrier Report and Order as well as safeguards set forth in section 272 of the federal Act. (FCC's Access Charge Order at ¶ 278.) The FCC, Ms. Yow recalled, observed that the Fifth Competitive Carrier Report and Order separation requirements have been in place for over ten years, and that non-BOC ILECs have been providing in-region, interexchange services on a separated basis with no substantiated complaints of a price squeeze. (*Id.* at ¶ 272.) ICC Staff Ex. 1.00 (Yow), at 20.

Ms. Yow testified that the FCC also concluded that requiring ILECs to offer services to their affiliates at tariffed rates or via negotiated interconnection agreements reduces the risk of a price squeeze to the extent that an affiliate's long-distance prices would have to exceed their costs for tariffed services. (*Id.* at ¶ 272.) ICC Staff Ex. 1.00 (Yow), at 20. Further, Ms. Yow noted that the FCC concluded that current conditions in markets for interexchange services make an anti-competitive price squeeze unlikely to occur as a result of its decision not to prescribe immediately access charge rates at forward-looking economic cost levels. (*Id.* at ¶ 280.) Ms. Yow noted, however, that this argument is predicated on the notion that the ILEC is in full compliance with Section 251 of the Act. Although Ms. Yow acknowledged that this may not be a realistic assumption, she thought it tempered by the fact that if Ameritech is not in full compliance with Section 251 of the federal Act it cannot comply with the requirements of Section 271 of the Act. ICC Staff Ex. 1.00 (Yow), at 21.

2. Non-Cost Based Intrastate Access Charges

Staff recommended that the intrastate PICC and RIC rate elements (once tandem switching revenues have been removed) as well as the Marketing Expense Recovery Charge ("MERC") and Information Services ("IS") rate elements should be eliminated from the intrastate access charge rate structure. Further, ILECs should be prohibited from introducing additional non-cost based elements in the future. Moreover, IXC's should be required to flow through these access charge rate reductions to end users through lower interexchange service rates. However, to the extent non-rural LECs can demonstrate that the revenues they recover from these non-cost based rate elements support their costs (total element long run incremental cost plus a reasonable amount of contribution) of providing a business or residential NAL, Staff recommended that the Commission allow these non-rural LECs to shift the recovery of the revenues associated with those rate elements either to the NALs or to an intrastate universal service fund. Staff Initial Brief, at 30; ICC Staff Ex. 1.00 (Yow), at 21-22.

Ms. Yow reasoned that the presence of non-cost based access charges has been traditionally justified by allegations that they support universal service. To the extent it is demonstrated that they do not, Ms. Yow thought there no reason to maintain them. ICC Staff Ex. 1.00 (Yow), at 22.

3. Proposals to Eliminate Non-Cost Based Access Charge Rate Elements

Staff observed that the type of proceeding needed to address the elimination of non-cost based rate elements would depend on two things: (1) the manner in which the non-rural LEC is regulated, as well as (2) whether or not the recovery of revenues associated with the intrastate RIC, PICC, MERC and IS are shifted to the LEC's NALs or to an intrastate universal service fund.

Regarding Ameritech, Staff noted that Ameritech is a Price Cap LEC in Illinois and is governed by an alternative regulation plan within Illinois. The Commission adopted Ameritech Illinois' current alternative regulation plan in 1994 in its Order in ICC Docket No. 92-0448/93-0239, Consol. ("Alt. Reg. Order"). Staff Initial Brief, at 33.

Ms. Yow opined that to the extent revenues are shifted from Ameritech's intrastate PICC to its NAL, that a rate rebalancing hearing would be required. ICC Staff Ex. 1.00 (Yow), at 22. Ms. Yow, however, expressed concern whether Ameritech's alternative regulation plan would prevent the rebalancing of its access and NAL rates. She was concerned because Ameritech's alternative regulation plan imposes a five-year cap on Ameritech's residential NAL rates and could, thus, impose a barrier to rebalancing Ameritech's access and NAL rates. (Alt. Reg. Order at 64.) ICC Staff Ex. 1.00 (Yow), at 23-24.

Ms. Yow thought that if the Commission concludes that Ameritech's intrastate PICC revenues should be eliminated and not recovered from its NAL, Ameritech would be entitled to petition the Commission for exogenous factor treatment under its current alternative regulation plan. ICC Staff Ex. 1.00 (Yow), at 24. Ms. Yow pointed out that in order to determine the magnitude of an exogenous factor treatment for a given service it is necessary to determine the demand for such service. Further, she noted that one must rely on recorded demand for a prior twelve-month period. (Alt. Reg. Order, App. at 3, 6.) ICC Staff Ex. 1.00 (Yow), at 24.

Ms. Yow testified that the reduction in Ameritech's non-cost based access charges could generate interexchange demand that is sufficiently large to off set the revenue reduction, and eliminate the need for exogenous factor treatment. Ms. Yow, however, thought this would be dependent on the flow through of access charge reductions by IXC's and ILECs who provide interexchange service to end users. ICC Staff Ex. 1.00 (Yow), at 25.

Regarding GTE, Ms. Yow testified that the Commission uses traditional rate of return regulation for GTE. Ms. Yow opined that to the extent GTE shifts revenues from its intrastate PICC and RIC to its NAL rates, a rate rebalancing proceeding would be needed. If the Commission concludes that GTE should not recover the revenues associated with its intrastate PICC and RIC, Ms. Yow thought that the Commission would need to initiate a rate case for GTE. Otherwise, Ms. Yow thought that the elimination of GTE's revenues might constitute single-issue ratemaking. ICC Staff Ex. 1.00 (Yow), at 26.

Ms. Yow noted that the reduction in GTE's non-cost based access charges does not necessarily mean that GTE will lose a significant amount of revenue because the access charge reduction could generate increased demand for access minutes of use to off set the revenue reduction. Although, Ms. Yow thought that the creation of new demand would be highly dependent on the flow through of access charge reductions by IXC's and ILEC's to end users. ICC Staff Ex. 1.00 (Yow), at 26-27.

4. Flow Through Issues

Ms. Yow explained that the flow through of access charge reductions from IXC's to end users is important because IXC's recover their payments to ILEC's of non-cost based access charges from end users through higher interexchange rates. ILEC's also recover the revenues associated with non-cost based access charges by setting their rates for interexchange calls at levels that satisfy imputation. To the extent these non-cost based access charges are eliminated, there is no reason for IXC's and ILEC's alike to continue recovering them from end users. Further, if recovery for non-cost based access charges is shifted to the end-users' NAL on the one hand, and IXC's/ILEC's continue to charge end-users pre-existing interexchange rate levels, end users will effectively be paying for non-cost based access charges twice. That is, once from the higher NAL rates and a second time from the unadjusted interexchange rates. ICC Staff Ex. 1.00 (Yow), at 27.

Ms. Yow testified that there are geographic rate averaging requirements for intrastate interexchange services that must be maintained. (See 47 USC §254(g).) Further, the FCC has adopted rules to implement Section 254(g). Under the FCC's rules, IXC's and ILEC's are required to average their rates for intrastate interexchange services. (FCC's Section 254(g) Order at ¶9.) Ms. Yow noted that the FCC concluded that Congress intended the states to play an active role in enforcing Section 254(g) with respect to intrastate geographic rate averaging. Finally, Ms. Yow noted that the States are free to establish intrastate rates as long as they are not inconsistent with its geographic rate averaging rules. (FCC's Section 254(g) Order at ¶46.) ICC Staff Ex. 1.00 (Yow), at 29.

Ms. Yow recommended that, based upon prior FCC orders, the flow through of access charge reductions to end users must be done on a statewide basis. Ms. Yow testified that the Commission could not approve a flow through proposal that reduces

the interexchange rates of some customers or customer classes but not others. ICC Staff Ex. 1.00 (Yow), at 29.

Ms. Yow testified that if the Commission adopts her recommendation to eliminate non-cost based rate elements, it should require IXC and ILEC to file, within the proceedings eliminating those rate elements, proposed tariffs which detail the intrastate toll rate reductions that would extend to end user customers. ICC Staff Ex. 1.00 (Yow), at 29-30. Ms. Yow opined that IXC and ILEC should not be allowed to offset revenue loss from those rate reductions through simultaneous rate increases. Additionally, she thought IXC and ILEC should not be allowed to condition eligibility for the reduced rates on subscription to the service, for a period exceeding one month. ICC Staff Ex. 1.00 (Yow), at 30. Ms. Yow contended that IXC and ILEC should not be allowed to condition the eligibility of their end users for the reduced rates on the purchase of other unrelated services (such as special features) or bundles of services. ICC Staff Ex. 1.00 (Yow), at 30-31.

Ms. Yow recommended that IXC and ILEC be required to file semi-annual reports with the Commission, demonstrating that the flow through has occurred. She thought this should be done by comparing the revenue changes resulting from all rate increases and decreases during the relevant period of time. These semi-annual reports should be filed with the Commission and Staff for a period of at least one year. This will ensure that end users become aware of the reduced interexchange rates. ICC Staff Ex. 1.00 (Yow), at 31.

B. AT&T

AT&T recommended that the Commission require all non-rural ILECs to eliminate their non-cost based rate elements and to base the prices of their remaining intrastate switched access rate elements upon long run service incremental cost ("LRSIC") studies by year-end 1999. AT&T noted that its position is consistent with the Commission's LRSIC rules contained in Code Parts 791 and 792 of the Illinois Administrative Code, which require non-rural ILECs to submit LRSIC studies for their tariffed services and to demonstrate that the prices for their tariffed services exceed the LRSIC of those services. AT&T Initial Brief, at 8.

AT&T contends that pricing switched access service rate elements at LRSIC based levels is crucial not just to promote competition in the access market and to guard against a price squeeze in the toll markets, but also to foster competition in the local market. AT&T pointed out that unless access charges are reduced to economic costs, plus a reasonable contribution to forward-looking shared and common costs, ILECs will continue to use the excess revenues they receive from those charges to fund their ongoing efforts to retard competition by forestalling widespread competitive entry by new entrants. AT&T also recommended that the cost of the retail NAL for the purpose of determining universal service support be based upon the LRSIC of the NAL and a reasonable allocation of shared costs. If the Commission deems it appropriate

for competitive and/or public interest reasons, AT&T recommended that the price of the retail NAL also include a reasonable allocation of forward-looking common costs. AT&T Initial Brief at 8-9.

AT&T witness Cathleen Conway recommended that the PICC and RIC be eliminated from intrastate access charges because they are non-cost based and neither of them are related to the provision of switched access services. Ms. Conway pointed out that the IS and the MERC are also non-cost based and not related to the provision of switched access services and should also be eliminated. AT&T Ex. 1.0 (Conway), at 5.

Ms. Conway explained that at the federal level, the interstate IS was established by the FCC to allow ILECs to recover costs associated with the publication of white page directories for their local service subscribers. She noted that the IS costs are not associated with the provision of switched access service but, rather, are associated with the provision of the NAL, given that a directory listing is included as part of that service offering. Ms. Conway observed that although Ameritech does not assess an intrastate IS, GTE and many rural ILECs in Illinois continue to do so. AT&T Ex. 1.0 (Conway), at 6.

Regarding the MERC, Ms. Conway testified that at the federal level, marketing expense costs/revenues have historically been allocated across all services according to the effective Separations Rules. In its Access Reform Order, the FCC removed marketing expense costs/revenues from all switched access rate elements in recognition of the fact that they were not involved in the provision of switched access service. CC Docket Nos. 96-262 Order, adopted May 7, 1997, at 7. The FCC directed that these revenues be placed in a newly created price cap basket. Contrary to the FCC's directives, GTE created a new rate element (the MERC), which it assesses on all carrier common line minutes of use. Only GTE has tariffed a MERC rate element in Illinois. AT&T Ex. 1.0 (Conway), at 7-8.

Ms. Conway testified that regardless of whether GTE recovers these costs via its retail rates, IXC's do not order or require MERCs, and these costs are not costs incurred in GTE's provision of switched access service. Consequently, Ms. Conway advocated that they should be eliminated from the intrastate access charge structure altogether. AT&T Ex. 1.0 (Conway), at 9.

Ms. Conway thought that if GTE can demonstrate that its NAL rates are not sufficient to cover all relevant forward looking costs, it may be appropriate to treat these costs in a rate rebalancing case implementing the policies which the Commission will adopt in this phase of this docket. However, because the NAL services in question -- multi-business and non-primary residential end user lines -- are not those included in the definition of universal services, the issue of affordability is not relevant. Instead, Ms. Conway thought that GTE could transition these costs to the NALs, or simply

forego these revenues, subject to the LRSIC policies of the Commission. AT&T Ex. 1.0 (Conway), at 10.

Ms. Conway testified that the Commission should include a prohibition against the establishment by ILECs of any future non-cost based access elements. The process for future access filings should not include only proposed rates, but also forward-looking cost studies in support of proposed rates and consistent with 83 IL Administrative Code Part 791. This way, any future non-cost based rate would automatically be rejected. AT&T Ex. 1.0 (Conway), at 10-11.

AT&T recommended that the Commission base the pricing of the remaining intrastate switched access rate elements upon LRSIC studies as soon as possible, allowing only for a sufficient mark-up toward forward-looking shared switched access costs and possibly a reasonable contribution toward forward-looking common costs. AT&T also recommended that the Commission use the forward-looking shared switched access cost percentage set forth at page three of AT&T Gebhardt Cross Ex. 1A (Proprietary). AT&T Initial Brief, at 12.

Ms. Conway testified that Ameritech and GTE should not continue to mirror their interstate cost based switched access rates. Ms. Conway noted that, unlike the FCC that lacked the necessary forward-looking cost information to prescribe access rates when it issued its Access Reform Order in May of 1997, the ICC has the requisite LRSIC studies to use to set switched access service rates. AT&T Ex. 1.0 (Conway), at 11.

Further, Ms. Conway reasoned that a mirror of interstate rates would, in principle, continue the very subsidization of local service that Staff has indicated should be eliminated by access reform. Ms. Conway observed that Ameritech alone includes over \$3 million of its federal universal service obligation in its federal price cap trunking basket. Consequently, Ms. Conway thought it entirely inappropriate to allow these companies to mirror these rates, given that they have no corresponding intrastate universal service fund obligation. AT&T Ex. 1.0 (Conway), at 12.

Like Ms. Conway, AT&T witness James Webber testified that the Commission should require all non-rural ILECs within Illinois to use LRSIC, as opposed to TELRIC studies, when pricing their switched access rate elements. Mr. Webber explained that Illinois ILECs are required to employ the LRSIC methodology under Code Parts 791 and 792 for cost studies, imputation and aggregate revenue analyses. TELRIC, on the other hand, is not required (or even defined) by the Illinois Administrative Code. TELRIC, Mr. Webber explained, was first defined in the FCC First Report and Order and has only been used for the pricing of interconnection and UNEs. Moreover, the TELRIC methodology applied in Illinois does not yield results that are directly applicable to Illinois' intrastate switched access elements. AT&T Ex. 2.0 (Webber), at 10.

Mr. Webber testified that although LRSIC and TELRIC methodologies are essentially similar in concept, the Commission implemented in the Ameritech UNE docket a methodology for TELRIC that differs from the Commission's established LRSIC rules. Mr. Webber explained that the Commission approved fundamental TELRIC inputs (plant lives, fill factors and cost of money) for Ameritech that are different from those currently used in Ameritech's LRSIC studies. Further, the shared and common costs attributed to network elements under the TELRIC methodology, as implemented in Illinois, are different from those that should be applied to the family of switched access service elements under the LRSIC approach as defined and routinely applied here in Illinois. Mr. Webber noted that Ameritech was allowed to recover certain non-volume sensitive ("NVS") costs in its TELRIC studies that have no relation to retail services or intrastate access services. AT&T Ex. 2.0 (Webber), at 11.

Mr. Webber testified that including such costs in access cost studies – and ultimately access rates – would artificially bias those costs in a manner that is utterly inconsistent with the Commission's previous application of its LRSIC rules. Equally important, inclusion of such costs would hinder the development of competition and help ensure that the ILECs continue to maintain the dominance in their markets. Mr. Webber pointed out that Ameritech has filed LRSIC access cost studies in response to data requests in this proceeding and GTE possesses LRSIC data for several of its access services at this time. AT&T Ex. 2.0 (Webber), at 11-12.

AT&T contends that a market-based approach is not working simply because there is no market. The primary reason there is no market is because both Ameritech and GTE have refused to provide the combination of unbundled network elements commonly referred to as the Platform. With the Platform, CLECs could already be providing access service in competition with incumbent LECs like Ameritech and GTE via the use of unbundled network elements. Without the Platform, they cannot. AT&T Initial Brief, at 15.

Ms. Conway testified that Ameritech's and GTE's refusal to provide the Platform has effectively precluded the very competition the FCC envisioned would occur when it adopted a market-based approach. Because the anticipated competition has not materialized, a prescriptive approach is necessary. AT&T Initial Brief, at 16-17; AT&T Ex. 1.0 (Conway), at 14.

Ms. Conway testified that by breaking the "mirror" and requiring the ILECs to base the rates for switched access service on forward-looking costs, the Commission will be bringing the benefits of competitive market pricing into the switched access service market which has not yet been subject to any market pressures to date. Because the end users are the ultimate causers of these costs, Ms. Conway reasoned that the Illinois end users will benefit from reduced toll rates as the IXC's, and hopefully Ameritech and GTE, reduce their intrastate toll rates. AT&T Ex. 1.0 (Conway), at 12-13.